BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 26, 1946

To Chairman Eccles

From Woodlief Thomas

Subject:

Attached is a draft of a memorandum entitled "Public Debt, Inflation and the Federal Reserve System" which represents the work of Mr. Goldenweiser with some revisions and additions by me. Charts to accompany the memorandum have been prepared and are now being duplicated. They should be ready tomorrow.

This should still be considered as a preliminary draft to be used as a basis for preparing the contemplated report to Congress. I believe it covers the main points that need to be made.

What distribution would you like to have made of this memorandum?

W. T.

Attachment

CONFIDENTIAL

DRAFT - EAG:WT

February 25, 1946

PUBLIC DEBT, INFLATION, AND THE FEDERAL RESERVE SYSTEM

Monetary conditions in the United States reflect the profound effects of the war on the economy. Superabundance of money, resulting from the growth in the public debt, together with a shortage of goods, has resulted in a heavy upward pressure on the price structure. In view of the monetary aspects of this situation, the Federal Reserve System has imperative duties to perform and vital responsibilities to discharge.

The phenomenal achievements of the American economic system in more than doubling its physical output of goods for the purpose of waging war has resulted in a threefold growth of money with which to buy goods, accompanying widespread shortages of raw materials and finished goods wanted and needed by the people. Through allocation of materials, rationing, and price controls prices have been kept from advancing as far or as fast as the monetary factors alone would have caused them to go. But with the war over, resistance to price advances becomes increasingly difficult so long as demand exceeds production.

Volume of Money and Inflation

There is a school of thought, reared largely during the depression, that the volume of money is a matter of indifference. This view is the outcome of experience in the 30's when additions to the money supply failed to cure the depression. But this view overlooks the fact that the effectiveness of the money supply is vastly different when there is, as at present, an almost unlimited demand for goods and great difficulty in obtaining them. At a time like this a large volume of money is a dangerous inflationary force. It leads to purchases of whatever can be obtained at whatever prices are asked or tolerated. It finds outlets in fields which are not covered by controls, such as securities and real estate. It increases purchases not only for use but also for resale at higher prices. It fosters speculation -- the harbinger and symptom of inflation. At a time like the present it is a matter of vital interest to the country to prevent a further growth in the money supply.

Responsibility of the Federal Reserve

The Federal Reserve System is charged with responsibility for so regulating the supply and cost of money as to contribute to the maintenance of economic stability. The Federal Reserve Act gives a number of different objectives and guides to policy for different lines of activity; these various statutory provisions are set out in full in Appendix A. In the final analysis they signify that the System must contribute, in so far as its means permit, to the prevention of rapid advances and declines in prices, production, employment, and national income.

In view of this responsibility placed upon the System by the Congress, it would be derelict in the discharge of its public obligation if at this time it failed to undertake whatever it can under the law to stop further expansion of bank credit and the money supply and to recommend to Congress such additional measures as may be necessary to increase its ability to accomplish this purpose.

Heritage of War Finance

Throughout the war efforts were made to raise as much of its cost by taxation as was feasible and to finance the rest in so far as possible by tapping the savings of the people. Fiscal and monetary authorities agreed throughout that financing through the banks, which results in the creation of new money, should be kept down to the necessary minimum. Nevertheless, under the pressure of the all-absorbing purpose of financing a winning war, a substantial proportion of the Government's financial requirements was met through the sale of Government securities to the banks.

Of the total funds raised to finance the war, which amounted to 382 billion dollars from July 1940 to December 1945, 153 billion dollars, or 40 per cent was obtained from taxes, while the remaining 60 per cent was borrowed -- somewhat more than half of the borrowings were from the savings of individuals and businesses and the rest was obtained by the sale of Government securities to banking systems. Whether more could have been raised through taxes and through the use of savings and less from the banks, as was advocated by many during the war, is a matter about which nothing can be done now. The fact is that as a net result of the war and its financing, as shown in Chart I, holdings of Government securities by all banks, including mutual savings banks and Federal Reserve Banks, and the total volume of bank deposits and of currency in circulation has increased by 110 billion dollars, that is, from 67 billion in June 1940 to 176 billion at the end of 1945. This growth in money was in part a necessary and desirable accompaniment of the rapidly expanding activities and abnormal needs of a wartime economy. As shown on Chart II, however, the increase in money has been more rapid than the tremendous expansion in the value of the country's total annual production of goods and services. As a consequence, the total amount of deposits and currency outstanding is much larger in relation to the value of the total annual product than at any time in history. With the reduction in working hours and the release of wartime pressures, the national product has declined from the wartime maximum and may be expected to continue below that peak unless there should be an inflationary rise in prices. The volume of money, however, is not likely to decrease.

The holdings of deposits and currency represent the buying power and deferred demands accumulated during the war; they will exert pressure on available supplies of goods, which are still inadequate to meet demands. In this situation it is essential that all efforts of the Federal Reserve System should be directed towards the prevention of a further expansion of bank credit and the money supply.

Role of Federal Reserve in War Finance

In order to discharge its obligations to the Government and the country during the war, the Federal Reserve System adopted a number of measures calculated to make it possible for banks to meet without delay and smoothly such needs of the Government as were not adequately supplied from taxation and from the borrowing of savings. Among the specific measures adopted to accomplish this purpose were the following:

(1) The Federal Open Market Committee, which conducts purchases and sales of Government securities for System accounts, established in 1942 a 3/8 per cent rate at which it was ready to buy all Treasury bills offered with an option to the sellers to repurchase the securities on the basis of the same rate at any time before they matured.

(2) Each Federal Reserve Bank established, in October 1942 a preferential rate of ½ of one per cent for advances to banks on Government securities with a maturity of not more than a year, while its regular discount rate was reduced to or held at 1 per cent.

(3) Vigorous support was given to the Government security market whenever it was necessary to maintain yields and to facilitate Treasury financing. Through this action the structure of interest rates was maintained at close to the very low levels which prevailed at the beginning of the war. The System purchased all securities offered in the market at the rates established and not otherwise absorbed.

Federal Reserve System purchases of Treasury bills at the established buying rate and of other securities offered at the prevailing structure of rates supplied banks with reserves, which they in turn used to buy additional Government securities or to obtain currency to meet the public's growing demand for cash. Thus Federal Reserve purchases of about 21 billion dollars of Government securities, during the war period, together with about 7 billion dollars of reserves in excess of requirements held by member banks in 1940, provided the basis for an expansion of

20 billion dollars of currency and a growth of 8 billion in member bank required reserves. These developments are illustrated in Chart III. The increase in required reserves supported a deposit expansion of about 50 billion dollars at member banks, not counting 24 billion of United States Government deposits against which reserves were not required to be held during the war. Indirectly they also provided the basis for deposit expansion at nonmember banks.

Besides enabling banks to meet the credit needs of the wartime economy, Federal Reserve policies of establishing especially low discount and buying rates on short-term securities were designed to encourage banks to purchase and hold short-term low-rate issues rather than longer-term issues. This objective was also furthered by Treasury policy, particularly during later years of the war, of prohibiting or restricting bank holdings of certain longer-term issues offered in the War Loan Drives. These policies were designed to help maintain the liquidity of banks and also to keep down their earnings on Government securities, which expanded considerably during the war.

One of the objectives of these measures was to maintain the structure of interest rates at close to the low levels prevailing at the beginning of the war. The trend of rates of various types of Government securities is shown on Chart IV. This served several purposes: it encouraged investors to purchase securities without waiting for lower prices and to hold them without fear of loss from price fluctuations. It kept the market free from disorderly movements. As previously mentioned, it also kept down bank earnings on the securities that banks were called upon to purchase. Finally, it held down the cost to the Treasury of interest charges on the greatly expanded public debt.

As a result of these policies and measures, World War II was financed by the Treasury at a relatively low rate of interest. With a public debt of 278 billion dollars the annual cost is only 5 billion, or an average of less than 2 per cent. This is a noteworthy achievement, but it is not a particularly difficult one to accomplish as long as the Federal Reserve stands ready to purchase from the market any securities offered at the established rates. During the past year the level of long term rates has been declining, while short term rates have generally held firm.

These wartime measures of the Federal Reserve System, which were pursued consistently throughout the period of hostilities and war financing, were of paramount importance during the struggle. With the coming of peace, the consequent decline in Government expenditures, and the passing of the necessity for increasing the public debt, and particularly bank holdings, these policies need to be reconsidered to determine whether their continued use would contribute to stability or instability of the Government security market, the banking system, and the economy in general.

Immediate Monetary Objectives

Objectives of monetary policy in the immediate future should be to combat the inflationary danger in so far as that can be done through the regulation of bank credit. It is recognized that inflation resulting from wartime developments cannot be stopped through adoption of new monetary restrictions alone; other weapons must be used as well; but monetary restrictions are an essential part of the arsenal of weapons that may be used to combat inflation.

Policies adopted during the war to make it possible for banks to meet expanding demands for currency and to increase their holdings of Government securities, when the Government had to borrow over 200 billion dollars, are not appropriate for a situation when the Treasury may be reducing rather than increasing the public debt and further monetary expansion is unnecessary.

The Treasury will continue to have a problem of refunding its short-term debt. Over 70 billion dollars of the marketable issues outstanding mature or are callable within a year and in addition large amounts of savings bonds and notes may be presented for redemption. Commercial banks hold about forty per cent and Federal Reserve Banks hold nearly 30 per cent of these issues. Under these circumstances, any measures adopted to restirct bank credit expansion that resulted in a rise in short-term interest rates would probably increase the cost to the Treasury of carrying debt and would also add to the already high earnings of commercial banks.

As already mentioned, the war has been financed at a relatively low interest cost. It is gratifying that the cost of the unprecedented public debt is no higher than it is. Nevertheless, the annual debt service is a heavy charge on the budget, equal to what not many years ago was more than the Government's entire budget. In order to alleviate the burden of taxation on the people it is important not to increase further the cost of the public debt. From this standpoint, therefore, it is desirable to maintain a generally low level of interest rates.

Customary Methods not Usable

Traditionally the principal method of the Federal Reserve System in attempting to regulate the supply and cost of money was to act through bank reserves by a variety of means provided for that purpose by the law. The System had means of affecting the volume of bank reserves by changing the proportion of deposits that must be held as reserves by the banks, and by adding to or subtracting from those reserves through the purchase or sale of Government securities in the market. In so far as banks are obliged to borrow from the Federal Reserve, the System can make that borrowing more or less costly by changing its discount rate.

These traditional methods, which generally brought about changes in the cost of money, i.e. in interest rates, as well as in the availability of money, would restrict some of the forces of expansion in the present situation but in more important respects they are largely inapplicable to problems of postwar monetary regulation. They could not be applied without raising short-term interest rates to some extent and thus affecting the interest cost to the Treasury.

Increased short-term interest rates would correct one of the existing forces of credit expansion. The present wide differentials between short-term and long-term rates encourage further bank credit expansion. This is true because banks can sell some of their short-term securities to Federal Reserve Banks, thus creating additional bank reserves, and then purchase in the market longer-term higher-yielding securities. It is profitable for banks to do this and also safe as long as the prices of all Government securities are stabilized. Whenever a bank makes such a shift the additional reserves thus created pass from bank to bank and provide the basis for a sixfold expansion of bank credit.

This shifting by banks from short-term into longer-term securities has been evident to an increasing extent during the past year or more. Charts V and VI illustrate the trend. Chart V shows how in early years of the war member banks increased their holdings of all types of Government securities; the growth in short-term bills, certificates, and notes was somewhat greater than that in bonds. Since 1944, however, holdings of bonds have increased more rapidly than those of notes and certificates and bank holdings of bills have declined. Federal Reserve Banks, on the other hand, as shown in Chart VI, rapidly increased their holdings of Treasury bills and more recently of certificates, while their small holdings of bonds declined.

Credit expansion resulting from bank shifting from short-term securities into longer-term securities in order to obtain higher returns could be checked by Federal Reserve refusal to purchase the short-term issues This would result in a rise in short-term yields to a point at which such shifts were no longer considered profitable. This, however, would raise the interest cost of the short-term debt to the Treasury and increase bank earnings on their holdings of short-term securities.

In view of greatly expanded volume of the public debt outstanding, any rise in the general level of interest rates may increase the cost of the public debt without effecting any substantial restriction on monetary expansion. The Federal Government debt, as shown on Chart VII, has grown to a point where it now amounts to nearly two-thirds of the entire volume of public and private debt, whereas before this war it was generally much less than a fourth of the total. Total private debt has shown little change in recent years and is still less than it was in the 1920s. A rise in the interest rate, therefore, would primarily affect the cost of the debt to the Government, which must be continually refunding its maturing issues. As long as banks and others hold large amounts of Government securities, which they can sell or refuse to replace at maturity, the customary restrictions on availability of credit and the consequent increases in interest rates would not exercise the restraining influence on bank expansion which they tended to exert when the bulk of debt originated from private business. Consequently, means must be devised for discouraging bank credit expansion without forcing the selling of Government securities and bringing about a rise in interest rates in the public debt.

Proposed Program

To attain the objectives of restricting further dangerous monetary expansion and at the same time not raise the interest cost to the Treasury, the Federal Reserve System has a series of policies under contemplation. These policies involve some changes in established procedures, which require new legislation. The System, therefore, wishes to place them before Congress for consideration for the purpose of obtaining from Congress a general directive, as well as such additional authority as may be necessary to carry out the directive.

These measures include some which are matters of Treasury policy and in all cases will affect the future management of the public debt and the refunding program. They thus raise questions of general Governmental policies and it is fitting that they be reviewed and considered by the Congress before adoption.

One proposal, which the System would make, requires action by the Treasury which has already taken steps along the lines suggested. This is the use by the Treasury of some of its large accumulated cash balance to reduce the public debt by retiring maturing issues instead of refunding them. Total cash holdings of the Treasury reached a maximum of 26 billion dollars early this year -- an amount far greater than will be needed to meet any contemplated deficit during the next two years. Since banks hold a large portion of the maturing issues, their retirement will reduce bank holdings of Government securities, as well as save the Treasury some interest costs.

Other measures will be needed, however, to restrain banks from purchasing additional securities in the market and thus maintaining or expanding the total volume of credit. For this purpose the Federal Reserve proposes: (1) to discontinue the preferential discount rate; (2) to discontinue the posted rate on bills by which the Federal Reserve undertakes at all times to buy all bills offered to it at a fixed rate; and (3) to devise a scheme by which banks would have to hold, in addition to their cash reserves, a specified proportion of their demand deposits in short-term Government securities.

Preferential discount rate. There is at present in effect at the Federal Reserve Banks a rate of 1/2 of one per cent on such advances as are made to the banks on the security of short-term Government obligations. This rate compares with a rate of one per cent for other advances. This preferential rate was established to encourage banks to purchase short-term securities and to enable them to meet temporary needs for reserves without liquidating their securities.

The rate has been utilized only to a relatively minor extent and bank borrowings have generally been low, except for short periods immediately preceeding war loan drives. Nevertheless, the rate stands as an inducement to banks to borrow from the Federal Reserve at a low rate for any purpose, including the buying of higher-rate Government securities. The banks can borrow from the Federal Reserve on their short-term securities and use the proceeds for acquiring higher-rate securities in the market. Such a practice at this time is contrary to the public interest and should not be encouraged by the continuance of the preferential rate.

Furthermore, under our system of reserves, borrowing from the Federal Reserve Banks, or selling securities to them, enables the member banks in the aggregate to purchase in the market, not only the amount that they borrow, but approximately six times that amount. It is because Federal Reserve money is reserve money, on the basis of which banks in the aggregate can erect a sixfold expansion of credit, that it is essential to discourage its use at the present time.

Discontinuance of the preferential discount rate would not increase the cost of borrowing to the Treasury. The Treasury at this time is not increasing its borrowings and the rates which it will pay for its refunding offerings are determined by market yields on its securities and not by the rate at which bank holders of those securities may borrow on them.

The maintenance of the rate places the Federal Reserve System in an ambiguous position of decrying expansion of bank credit and at the same time maintaining a rate that tends to encourage banks to expand further through the purchase of Government securities on the basis of Reserve Bank credit.

Bill buying rate. Similarly the Federal Reserve should no longer have a posted rate at which it is prepared to buy all Treasury bills offered to it. The prevailing 3/8 per cent rate was established at a time when the Treasury was rapidly increasing its debt and the banks had considerable excess reserves. It was thought desirable for banks to utilize these reserves in buying Treasury bills rather than to make it necessary for the Federal Reserve to create additional reserves. It was a part of an educational campaign to make the banks feel that, if they had Treasury bills in their portfolios, they were in as good position to meet drains on their reserves as they would be, if they kept the reserves idle. They could always sell the bills to the Federal Reserve and so increase their reserve balances and they could do so with the assurance that, if they wanted the bills back, they had an option for their repurchase.

This was an effective device for facilitating the financing of the Government's war requirements and it was utilized on a large scale. At present the Federal Reserve Banks hold $13 billions of the total of $17 billions of Treasury bills outstanding. Because of the low rate on these issues commercial banks hold only such amounts as they find helpful in adjusting their day-to-day reserve positions.

In view of the changed situation it is desirable now to discontinue the posted rate on bills and to let such purchases of bills as may become necessary in connection with the current situation be made at the initiative of the Federal Open Market Committee rather than at the unregulated option of commercial banks. In order to avoid increasing the cost of borrowing to the Treasury, it is proposed that a large portion of Federal Reserve holdings of bills be exchanged for certificates bearing a low rate of interest, say 1/8 of one per cent, while bills offered in the market would continue to be supported by the Federal Reserve but at rates which would make them more attractive as market instruments. It is no longer desirable, however, to have the banks feel that bills are automatically convertible into cash at their option and at a fixed rate.

The continuance of the fixed buying rate in the present circumstances is inconsistent with the System's responsibility for discouraging credit expansion, because the fixed rate offers to the banks an inducement to obtain funds from the Reserve at low rates and in an amount limited only by their holdings of Treasury bills and makes it possible for them, after obtaining these funds, to purchase in the market higher-rate securities amounting to several times the bills sold.

U. S. Government security reserve. In addition to the policy actions described above, the Board recommends that a law be enacted permitting the Federal Reserve Board to require banks to hold in the form of Treasury bills or Treasury certificates an amount equivalent to some proportion of their net demand deposits, possibly as much as 60 per cent. Details of this proposal, the manner of its operation, and its application to the banking system are discussed more fully in Appendix B.

Adoption of this proposal will have several advantages. It will help to check further bank credit expansion and the growth in bank earnings, will facilitate the management of the public debt, support the low short-term rate, and arrest the decline in the long-term rate, and will be an aid to many institutions that affect the welfare of the masses of the people.

In the first place, such a requirement could be used to restrain banks from selling to the Reserve Banks large amounts of short-term securities and buying longer-term issues in the market. This would remove an important potential source of bank-reserve creation and multiple credit expansion on the basis of those reserves, which is inherent in the present policy of stabilizing the existing wide differential between short-term and long-term rates. It would make possible the maintenance of a low level of rates on short-term securities held by banks and at the same time prevent a shift into the higher-yielding longer-term issues.

Banks could be required to hold short-term Government securities with interest rates not exceeding 7/8 per cent in considerably larger volume than they hold now. Since the banks do not have any substantial amount of excess reserves, such a requirement would necessitate their selling some of their longer-term securities in order to acquire the required amount of short-term securities. As a consequence, short-term rates and yields might go down further. The banks would buy some of the bills and certificates now held by the Federal Reserve Banks, and this would have the further advantage of reducing the basis of bank credit. On the other hand, the banks might have to sell some of the longer-term bonds and that would have the effect of stopping the further decline in the yields on long-term Government securities and possibly making the yields go up somewhat.

This requirement could be used to restrict the growth or bring about a decrease in the earnings of commercial banks, which have been at an extremely high level as the result of the expansion of their holdings of Government securities. The rate of return for commercial banks on their holdings of Government securities, which have greatly expanded and have carried bank assets to a high ratio in relation to their capital funds, should be low, because the securities carry no risk. The Government should not pay to the banks more than a reasonable return for handling the deposits and other business created through the purchase of these securities.

Banks' earnings on their loans and investments, of which Government securities form about 75 per cent, have greatly increased and at the present time represent a return on the bank's capital higher than that earned by capital invested in other more risky undertakings. If the banks are required to hold a large part of their portfolio in short-term Government securities carrying low interest rates, the bank earning situation may be expected to adjust itself to a more reasonable and equitable basis.

This proposal will also have the advantage of guaranteeing bank liquidity because the banks will have a large volume of short-term securities with no capital risks. Banks losing deposits to other banks could readily sell their short-term securities to the banks gaining the deposits, because the growing banks would be required to hold an increased amount of such assets.

After the new requirement has been put into effect and adjustment made to it, the fact that the banks will hold much fewer longer-term Governments will make the management of the debt considerably easier because the long-term securities would find permanent lodgment with genuine long-term investors who would not be so likely to sell their Governments. Banks in the past have sold Government securities for the purpose of meeting drains or of realizing profits. At times waves of bank selling have resulted in disorganized conditions in the U. S. Government securities market and have necessitated intervention by the Federal Reserve. These practices, which are natural for individual banks, are not in the general interest and the proposal here made is intended to diminish the likelihood of their occurrence.

The Federal Reserve System, however, would continue to stand ready through open-market operations to maintain an orderly market for United States Government obligations.

Effect of Proposals on Long-Term Interest Rates

It has been indicated that one effect of the proposed short-term security reserve requirement would be to check the decline in market yields on long-term bonds. It would, however, not result in a rise in those yields sufficient to reduce prices of bonds below par, so long as the Federal Reserve System stood ready to support the market. This aspect of the matter requires further explanation.

Cessation of the decline in market yields on longer-term securities or even some rise in these yields would in no way affect the Treasury's cost because the Treasury is not now issuing long-term bonds. It would merely mean that the decline in long-term rates, which has been continuous for a long time, would be arrested. The present very low yields serve no public purpose because they apply to existing securities on which the Treasury has to pay the coupon rate regardless of what the yield might be. The decline in yields merely reflects a rise in prices of the securities in the hands of present holders. The premium already gained by holders of Government securities has amounted to several billion dollars. What has happened is that, without any benefit to the Treasury which has to pay the coupon rate, long-term rates have declined with a profit to temporary holders and speculators at the expense of permanent investors who have to buy them at a premium and consequently earn a lower rate on their investment. The decline in yields on long-term bonds has not been confined to United States Government securities but has affected other bonds and has diminished the return on all investments.

It is clear that this movement is of no advantage to the Treasury and serves no public purpose. At the same time it is hurtful to a large number of institutions, such as insurance companies, educational endowments and trusts, philanthropic organizations and others which depend for their income on the return on long-term investments and which represent the interests of tens of millions of the people.

The Board, however, is not concerned about maintaining any special rate on long-term bonds. If our economy produces more investment funds than there are outlets, a decline in rates is inevitable and should not be artificially prevented. The institutions depending on returns on their investments will then have to adjust themselves gradually to the economic and financial condition of the country. This is different, however, from having the rate artificially hammered down by a constant bidding for securities by the banks. Bank purchases create new money which do not reflect savings or capital formation by the people. Since further bank purchases of Government securities are dependent on easy access to additional resources from the Federal Reserve Banks, the System has a direct responsibility in this matter. Furthermore, the decline in long-term interest rates results in a rise of security prices in the stock market because, as the long-term rate goes down, established dividend rates can support higher stock prices. This has been an important factor in the continuous rise of these prices which has lasted for several years. In this field values have advanced without let or hindrance. The advance in real estate values has also been influenced to some extent by the decline in the long-term rate.

While low long-term interest rates are generally desirable as a means of stimulating economic activity, it is questionable whether a further decline in rates resulting from bank credit expansion is in the public interest at this time. The available supply of investable funds is large and needs no addition, at the same time the demand for such funds for expansion of fixed assets exceeds the supply of goods available for such purposes and needs no new stimulus. In fact existing pressures are already so great as to threaten an inflationary development of dangerous proportions.

Conclusion

In the Board's opinion, adoption of the series of proposals here made, including policy actions under existing law as well as enactment of new legislation, would be in line with the System's obligation to contribute to the struggle against the inflationary danger.

In laying this program before Congress the Federal Reserve System is motivated by the fact that the country is facing a grave danger. The System desires to have a clear-cut directive from the Congress both in the exercise of its existing powers and in the acquisition of the new powers which are here recommended. If it is the wish of Congress to handle the matter in another way, the System begs to be informed of the desires of Congress. There is no time to waste. The forces of inflation are gathering momentum and such action as is to be taken to combat them must not be tardy. The cost to the country might be too great.